Statement of the
American Farm Bureau Federation

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American Farm Bureau Federation
for the
House Ways and Means Committee

Subcommittee on Select Revenue Measures
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Small Business and Pass-Through Entity Tax Reform Discussion Draft

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Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral, repeal the Alternative Minimum Tax (AMT), and be fair to farmers and ranchers. We commend the Ways and Means Committee on its methodical approach to tax reform through the release of discussion drafts, including the Small Business and Pass-Through Entity Tax Reform Discussion Draft that is the subject of today's hearing.

Cash Accounting

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes over a period of time than taxpayers with more stable incomes, unless they are allowed to take advantage of tax tools to even out taxable income. Cash accounting, combined with the ability to accelerate expenses and defer income, gives farmers and ranchers the flexibility to manage their tax burden on an annual basis by allowing them to target an optimum level of taxable income.

Cash accounting tools that are important to farmers and ranchers include the deferral of commodity and product receipts and prepaying the cost of livestock feed, fertilizer and other farm supplies. The option to prepay input costs gives farmers and ranchers the flexibility they need to plan for major business investments. For example, many farmers and ranchers forward contract their fertilizer for the next year's crop to guarantee availability and/or to lock in the best price. This ability to pre-pay input costs is especially important because farm production expenses are rising, with 2013 costs forecast to be 5.7 percent higher than 2012 and 42 percent higher than the 2002 through 2011 average.

Generally, farming businesses are not currently covered by the requirement that taxpayers with over $5 million of average annual gross receipts must use accrual accounting. However, a family farm corporation is required to use accrual accounting if it has gross receipts of more than $25 million for any tax year since 1985. A family corporation is one where 50 percent or more of the corporation stock is held by one (or in some limited cases two or three) families. In addition, a partnership that has a corporation as a partner can't use cash accounting.

The Ways and Means Committee discussion draft for reforming the taxation of small businesses proposes eliminating the special exceptions for farming businesses and makes them subject to the general limitation on the use of cash accounting method. Those limitations would be that business entities (i.e. C-corps, S-corps, and partnerships) with average gross receipts of $10 million or more for the three prior taxable years must use accrual accounting. Sole proprietors would be able to continue to use cash accounting without limitation.

While the proposed changes to cash accounting rules may simplify the tax code, it will have the opposite effect on farm and ranch taxpayers who are required to switch from cash to accrual accounting. The extra required bookkeeping, including but not limited to tracking inventory, accounts receivables and accounts payable, will be both time-consuming and costly to farm and ranch operations. Farmers and ranchers will either have to take time away from running their businesses or pay for help to comply. Both are harmful in an industry with tight profit margins, unpredictable income streams and an inability to pass on added expenses to customers.

Farm Bureau supports the continuation of unrestricted cash accounting currently available to most farmers and ranchers and cautions against reducing the number of partnerships, S-corps and C-corps farms and ranches eligible to use it.

Section 179 Small Business Expensing

Farming and ranching requires large investments in machinery, equipment and other depreciable capital. Due to these large capital investments, farmers and ranchers place great value on tax code provisions that allow them to write off capital expenditures in the year that purchases are made. Section 179 small business expensing that provides accelerated expensing and depreciation allows farmers and ranchers to better manage cash flow, minimize tax liabilities and reduce borrowing. The ability to immediately expense capital purchases also offers the benefits of lessening the record keeping burdens associated with the depreciation.

Under Section 179, farmers and other qualifying small businesses can immediately deduct the full cost of purchased business property, single-purpose agriculture structures, petroleum storage facilities and off-the-shelf computer software that are used in their farming business. For 2013 the maximum amount a taxpayer can expense under Section 179 is $500,000 reduced dollar for dollar by the amount that expenses exceed $2 million. These thresholds are temporary and will shrink to a $25,000 limitation with a $200,000 threshold for 2014. The Ways and Means Committee discussion draft for reforming the taxation of small businesses proposes a permanent $250,000 expensing limit that would be reduced dollar for dollar when expenses exceed $800,000. The amounts are indexed for inflation.

According to 2010 USDA Agricultural Resource Management Survey (ARMS) data, farm and ranch capital investments averaged $32,000 for those making investments. In addition, about 18 percent of all farms reported investing more than the prior 2012 expensing limit ($139,000) and more than 1 percent invested more than $500,000. But these facts don't tell a complete story because they don't account for the cyclical nature of farming and ranching. Whether caused by unpredictable weather that affects crop yields or uncontrollable markets that set the price of goods sold, it is not uncommon for farmers and ranchers to have a year of high income followed by several lean years. In a year when a farm business turns a profit and is able to make a major purchase, a combine for $350,000 or a tractor for $200,000, business expenditures will spike and can easily exceed the proposed $250,000 cap and the $800,000 threshold.

If the Section 179 small business exemption and threshold are allowed to drop at the end of the year, farmers and ranchers will lose some of the accounting flexibility they need to manage their businesses for success and growth in an industry that is cyclical in nature. For these reasons, Farm Bureau supports maintaining the $500,000 Section 179 small business expensing limitation and not reducing the $2 million acquisition limit.

Section 263A Unicap Rules

Uniform capitalization rules are complex and are a record keeping burden for those who grow plants for resale and for those who grow perennial crops. A grower must include certain direct and indirect costs in the basis of property and then recover these costs through depreciation or at the time of sale when there is a preproductive period of more than two years. Farm Bureau supports excluding businesses with less than $10 million of average annual gross receipts from the uniform capitalization rules as proposed by the small business discussion draft.

Since the discussion draft proposes to eliminate Section 263A requirements for businesses with gross receipts of less than $10 million, farmers and ranchers should be allowed to use the same depreciation methods as other taxpayers. In 1987, in a compromise that allowed producers of livestock an exception from Unicap requirements, all farm producers were restricted from using the 200-percent declining balance method of depreciation. With the elimination of Section 263A for the vast majority of farmers, the policy reason for limiting farm depreciation methods is moot.

Summary

Due to uncertain and fluctuating income that results from weather uncertainty and the unpredictable nature of markets, farmers and ranchers need a tax code that allows them to manage the risks associated with agriculture while complying with tax liabilities under the law. Cash accounting combined with the ability to accelerate expenses and defer income provides farmers and ranchers the flexibility they need to manage their tax burden. Section 179 small business expensing provides farmers and ranchers with a way to reduce borrowing and allows them to maximize business purchases in years when they have positive cash flow. For these reasons, we warn against reducing the number of farms and ranches eligible to use cash accounting and support maintaining the current $500,000 Section 179 small business expensing limitation and the $2 million acquisition limit.